MACRO-ECONOMIC POLICIES

Stability and self-sustained growth

Pak. Eco
The News
27.1.03

13A

By Aftab Ahmad Khan

The macro economic policy framework of fiscal, monetary and trade policies is critical to the achievement of the objective of high growth in a milieu of relative price stability and sustainable balance of payments. It is the effective integration of appropriate fiscal, monetary and trade policies that can help to augment savings and investment efficiently while avoiding uncomfortable inflationary pressures and excessive balance of payments deficits. Unfortunately, in Pakistan as well as in many other developing countries this integration has not always been achieved. Inadequacy of voluntary savings in the face of many competing demands on them has quite frequently led to excessive credit creation with its inflationary consequences which in turn has distorted resource allocations, generated speculation in financial and other asset markets and led to both adverse re-distributive effects and a weakening of the balance of payments. Both growth and equity have suffered. The basic responsibility of macro-economic management, therefore, consists of both demand management in the short run and supply expansion in the long run. Fiscal, monetary and trade policies have to be not only appropriate but mutually consistent.

Fiscal policy remains an instrument of state policy, both in developed and developing countries. Instruments of fiscal policy like taxation, public expenditure, user charges and borrowing influence production and distribution of incomes. Central government expenditures to-day average 25 per cent of Gross National Product (GNP) of developing countries. Obviously, it's impact on various aspects of the economy such as resource use and financing patterns is considerable. In developing countries fiscal policy has therefore emerged as a powerful tool for not only regulation of the economy but also for determining the level and directing the pattern of investment.

One obvious objective of fiscal policy is the need to abjure unsustainable fiscal deficits in view of their inflationary and balance of payments consequences.

Fiscal policy has also an important role in promoting not only savings in the household and private corporate sectors through modulated tax policies but also as an instrument of promoting public savings through a well framed tax policy and through adequate resources from the operation of public enterprises by levying appropriate user charges. Public financial policies on the spending side can determine the investment pattern, especially in the areas of social overhead capital and thus play an important part in poverty alleviation and building up human capital. The allocation of public funds is not less important than raising funds.

In Pakistan large budgetary deficit (i.e. the excess of government expenditure over ordinary revenues) is currently a serious macro-problem. During the 1990s, fiscal deficit averaged around 7 per cent of Gross Domestic Product (GDP), despite reduction in development spending by almost 3.5 percentage points of GDP. This inevitably resulted in pushing up public debt to an unsustainable level by the end of 1990s. The escalating burden of public debt over the years not only posed difficulties for fiscal adjustment but also crowded out private investment aside from forcing public investment to decline. In the current fiscal year (2002-2003), the government hopes to bring down the fiscal deficit to 4.6 per cent of GDP.

It is obvious that Pakistan has to control and reverse the trend of large fiscal deficits. Experience of a number of developing countries with large fiscal deficits shows that they can lead to a trap wherein an upward spiralling cycle of inflation — devaluation — rising interest rates — rising wages and salaries — rising inflation could disrupt production and investment and could lead to large-scale capital flight. All this highlights the importance of a significant fiscal adjustment in Pakistan involving a major resource mobilisation effort and expenditure control/rationalisation measures accompanied by steps aimed at improving tax administration.

Monetary policy in the context of development has both functional

RATES OF GROWTH OF GROSS DOMESTIC PRODUCT (GDP), MONETARY ASSETS (M2) AND CONSUMER PRICES

Years	Growth rate of real GDP at factor cost	Growth rate of monetary assets (M2)	Rate of increase in consumer prices
1990-91	5.4	17.4	12.7
1991-92	7.6	26.2	10.6
1992-93	2.1	17.8	9.8
1993-94	4.4	18.1	11.3
1994-95	5.1	17.2	13.0
1995-96	6.6	13.8	10.8
1996-97	1.7	12.2	11.8
1997-98	3.5	14.5	7.8
1998-99	4.2	6.2	5.7
1999-2000	3.9	9.4	3.6
2000-01	2.5	9.0	4.4
2001-02	3.6	14.8	3.5
Average	4.2	14.7	8.8

Source: State Bank of Pakistan.

and institutional dimensions. The functional dimension relates to the maintenance of price stability and avoidance of imbalances between monetary claims and real availabilities.

A growing economy needs an expanding money supply owing to higher output, the extension of the monetised sector and the increasing cash balance requirements of the community. As money supply expansion has it's counterpart in the expansion of monetary assets of the central bank, the concern with ensuring the appropriate degree of monetary expansion (i.e. without engendering inflation) translates itself into a rational allocation of monetary assets in the form of claims on the government sector and the private sector after taking into account claims on the foreign sector.

Experience of several countries (including Pakistan) indicates that huge fiscal deficits have often resulted in unplanned and excessive monetary expansion and the crowding out of the private sector of the economy. In such situations the room for manoeuvre of the monetary authorities tends to be restricted to attempting to offset the unhealthy impact of monetary ecstasy by limiting the secondary expansion of credit. In Pakistan the close link between monetary expansion and inflation is evident from the accompanying table.

The other area of monetary policy responsibility is with regard to the cost of money i.e. interest/mark up rates. It is necessary that mark up/interest rates be positive in real terms as an instrument for saving mobilisation. The problem with administered mark up/interest rates (apart from complexity and rigidity they introduce into the system) is that these are frequently fixed at a level that tends to yield low or negative real rates.

The other major promotional role of monetary policy in the growth context is to help build up the financial structure geographically wide and functionally varied to serve the needs of a growing economy both to enhance and mobilise financial savings and to allocate these in an efficient and optimal manner. This calls for an activist promotional policy in terms of expanding the coverage of the banking system and the creation of specialised institutions to serve the special needs of agriculture, term finance for industry, exports small business and *housing*. The development of money and capital markets would widen the spectrum of financial assets and give both the saver and investor an enlarged range of choice.

In view of the balance of payments constraints to growth, developing countries have tended to intervene directly in international trade and trade related investment.

— Continued on page 19

photo policies ...

— *Continued from page 17*

While the rationale and logic of import substitution especially in countries with an adequate factor endowment and a growing domestic market cannot be questioned, the manner of its implementation in many countries led to inadequate attention being paid to economy and efficiency. Import substitution came to be identified with physical rather than economic import substitution and in the process led to the emergence of high cost economy and thus weakening international trade strength of counties. Several developing countries e.g. South Korea and Taiwan, have on the other hand used import substitution in a manner that has promoted economy and efficiency and thus established a base for robust export expansion in the longer run. Developing countries would do well to gradually open up their markets and allow a greater competitive edge to their exports so that external viability does not become a victim of growth effort.

In Pakistan, in line with the recent emphasis on liberalisation, de-regulation and greater integration with the global economy, the government has reduced the maximum tariff rate from 65 per cent in 1995-96 to 25 per cent in 2002-03. With this reduction effective from July 2002, only 4 tariff slabs, i.e. 25, 20,10 and 5 per cent will prevail. With a view to encouraging diversification of exports and reducing heavy reliance on the textiles sector that currently contributes more than 60 per cent to Pakistan's total export earnings, the government has announced various incentives for the growth of the non-traditional exports. These include reduction in customs duty for the imports of necessary materials for such exports and a freight subsidy for the export of new products.

mic vision and